State Investment Commission

Monthly Meeting Minutes
Wednesday, May 27, 2015
9:00 a.m.
Room 205, State House

The Monthly Meeting of the State Investment Commission (SIC) was called to order at 9:04 a.m., Wednesday, May 27, 2015 in Room 205, State House.

I. Roll Call of Members

The following members were present: Mr. J. Michael Costello, Mr. Thomas Fay, Mr. Thomas Mullaney, Ms. Faith LaSalle, Mr. Frank Karpinski and Treasurer Seth Magaziner.
Also in attendance:
Mr. Thomas Lynch of Cliffwater, alternative investment consultant; Ms. Sally Dowling of Adler Pollock Sheehan; Mr. Greg Balewicz, Mr. Scott Conlon and Ms. Jennifer Bender of State Street Global Advisors; Ms. Anne-Marie Fink, chief investment officer, and members of the Treasurer's staff. Treasurer Magaziner called the meeting to order at 9:04 a.m.

II. Approval of Minutes

On a motion by Mr. Thomas Fay and seconded by Mr. Thomas Mullaney, it was unanimously
VOTED: to approve the draft of the minutes of the April 29, 2015 meeting of the State Investment Commission.

III. Review of Equity Factor Tilts – State Street Global Advisors

Mr. Conlon reviewed the investment philosophies around advanced beta. He described the factors that represent advanced beta within the equity space. SSgA believes advanced beta returns can be captured in a very transparent low-cost investment vehicle. Portfolios can be constructed in a manner aligned with investors' beliefs and objectives. He said the most successful investors with the strategies are those who have reasonable long-term investments horizons, who recognize that single factor performance is cyclical, and look to allocate across multiple factors. He gave some examples of multi-factor portfolios and how they are built. The factors should have low or negative correlation to each other.
He added that over the recent years, investors are taking a harder look at ways to improve their traditional passive portfolios. He believes investors will continue to increase allocations to these types of portfolios in the coming years.
He said in developing a factor portfolio for ERSRI they have incorporated value, quality and momentum as the diversifying factors.

Ms. Bender said she sees value, quality and momentum as being a good diversifying mix. Value and momentum, in particular, are natural offsets. Their approach to the implementation is to keep it straightforward and simple. She stated there are two main decisions to make, how much of the portfolio to put into the factor-weighted allocation and how to weight the stocks chosen. They like the approach where they tilt away from market cap.

Ms. Fink explained why they focused on the three factors, value, quality and momentum. She said the question to the SIC is how much tracking error they would be comfortable with.

The board asked questions and discussed.

Ms. Fink said she sees the equity allocation being half in market-cap weighted and half in factor weighted. She believes the portfolio would then get the benefits of the factor performance and also the advantages of the diversification.

Treasurer Magaziner asked about how quality might be defined.

Ms. Bender said there are a few of different measures in play. Return on equity, return on assets and returns on invested capital are all very highly correlated, so they are focusing on return on equity. Earnings variability and the use of leverage are the other components of the quality measure. What they are recommending is to down-weight leverage because they don't want to offset value.

Treasurer Magaziner said that the board would continue to discuss this topic.

IV. Cliffwater Hedge Fund Recommendation - Ascend Capital

Ms. Fink said in an effort to increase alpha return while not increasing fees, Cliffwater and staff have found a couple opportunities with some existing funds.

Mr. Lynch said the recommendations are for the hedge fund portfolio. Both hedge fund portfolios have been exceeding their benchmarks since their inceptions and fulfilling the role they have. Staff and Cliffwater have been looking at ways to enhance the program. They have identified two opportunities for enhancement. The enhancement would be taking two existing funds and altering the strategy to get more expected alpha return for the same level of fee. In both cases, the funds' leverage would also be increasing. Cliffwater believes the level of risk is appropriate for the funds' strategies as well as for the ERSRI portfolio.
Through ongoing monitor of all the hedge funds, Cliffwater has identified Ascend Partners II as one opportunity. ERSRI currently has $73 million invested with Ascend. The fund is part of the global equity portfolio.
Mr. Lynch reviewed the performance of the fund. He said the strategy is designed to run at low leverage with gross exposure averaging about 125%. That's low relative to other long-short managers who average gross exposure of 177%. Ascend Capital has offered ERSRI a product that follows the same strategy but with 1.5 times the positions as the current fund.
He went on to give a brief overview of the firm and the fund. The fund had an annualized return of 7% with a level of risk of 4%. In terms of risk, it's lower than 96% of equity long-short managers.
Ascend Capital is offering this option at the same level of fees, a management fee of 1.5% and a performance fee of 20%. They offer a fund-of-one structure that provides all the same terms, operating expenses and liquidity as ERSRI's current Ascend fund. Cliffwater recommends transferring the entire investment in Ascend Partners II to this new fund.

The board asked some questions and discussed.

On a motion by Mr. Thomas Mullaney and seconded by Mr. Thomas Fay, it was unanimously
VOTED: to approve a new structure of the Ascend Partners investment.

V. Cliffwater Hedge Fund Recommendation - Graham Capital

Mr. Lynch said Graham Capital is offering a similar option as Ascend Capital. He gave some background on ERSRI's current Graham Capital investment. The strategy is in the absolute return portfolio and basically

has no beta. As of April 30, ERSRI has an investment of $56 million in the Graham Capital Discretionary 6V fund. Graham is offering ERSRI the opportunity to switch into the Absolute Return fund, which is a strategy with higher expected risk and returns.
Mr. Lynch described the difference in strategy. In the current fund Graham targets approximately 6% volatility. The target volatility in the Absolute Return portfolio is approximately 11%. The higher volatility comes primarily through larger positions and additional leverage.
He gave a brief overview of the firm and their strategy. He mentioned Cliffwater measures leverage for this type of strategy through the margin-to-equity ratio. Graham's Discretionary fund has about 25% margin-to-equity ratio while the Absolute Return portfolio has averaged 50% since inception.
Since inception, the Absolute Return fund has produced an annualized return of 13.67% with risk of 9.8%. It ranks in the top 10% among similar strategies. It has generated much higher returns than the Discretionary fund with a higher risk level. He noted that it has a reasonable-to-low level of risk for this strategy.

Mr. Lynch reviewed the investment terms. Graham Capital is offering the new strategy at the same fees. The fees are 1.75% management fee and a performance fee of 20%. New investors into this fund would pay a management fee of 2.5% and a performance fee of 25%.
He added that about half the capital in the Absolute Return fund is the manager's capital so there is good alignment of interest. Cliffwater recommends transferring the entire amount in the discretionary fund to the absolute return fund.

The board asked questions and discussed.

Ms. Fink added that she liked the alignment of interest. She believes the fund would get more diversification as there are a few more underlying portfolio managers and strategies in the Absolute Return fund. Also, ERSRI would be taking higher leverage but not paying any more fees for it.

On a motion by Mr. Thomas Mullaney and seconded by Ms. Faith LaSalle, it was unanimously
VOTED: to approve a fund change with Graham Capital from the Graham Discretionary Strategies Fund to the Graham Absolute Return Fund.

VI. Consideration of Defined Benefit Investment Policy Statements – Core Fixed, Inflation-Linked & Credit

Ms. Fink reviewed the Investment Policy statement drafts. She noted the draft had been distributed at the previous meeting and asked the board for their approval.

On a motion by Mr. Michael Costello and seconded by Ms. Faith LaSalle, it was unanimously
VOTED: to approve the Core-Fixed, Inflation-Linked and Credit Investment Policy Statements.

VII. Transparency Pledge Recommendation

Treasurer Magaziner noted the national and local debate about disclosures that public pension funds should make about performance and fund managers. He said he doesn't want ERSRI to disclose any manager information that would have a detrimental impact on the performance of the portfolio. On the other hand, there is certain basic information that the public ought to know such as who fund managers are, their performance, liquidity, and fees and expenses paid.
He said he feels comfortable that disclosure of this basic level of information will not have a detrimental impact on performance. National discussion on disclosure has really shifted in the past few years.
In an attempt to codify a basic level of disclosure, it is good to have a policy in place. He said this policy

would apply to new fund managers going forward. Staff will also ask existing managers to voluntarily allow these disclosures. ERSRI would ask managers to sign a pledge understanding that they have the right to publish this information.
The board asked questions and discussed.

On a motion by Mr. Thomas Mullaney and seconded by Mr. Thomas Fay, it was unanimously
VOTED: to approve the Transparency Pledge.

VIII. Legal Counsel Report

Sally Dowling stated she had nothing to report.

IX. Chief Investment Officer Report

Ms. Fink reviewed the performance of the portfolio and the market environment for the month of April. The fund had a 1.6% return on the month, which was in line with the 60/40 basic allocation and about 0.20% less than the bottom-up benchmark. That underperformance was due mostly to hedge funds because the beta in the bottom-up benchmarks is higher. She reviewed the performance by asset class. The portfolio continues to have better return and less risk than the benchmarks.
She added that she and staff will continue spend a lot of time looking at factor tilts. Also, as part of the transparency initiative, Treasurer Magaziner has announced that they are looking to do a governance review in the next few months. They will also continue to work on the consolidated investment policy statement.

X. Treasurer's General Comments

Treasurer Magaziner noted that as part of the transparency effort various new web pages have been launched containing investment information and performance data.
He announced that there will be a few member changes as Mr. Bob Giudici and Mr. Drew Reilly will be retiring from the commission. The State Senate will confirm replacements in the coming weeks.
He thanked the members for their time and their efforts.

There being no other business to come before the Board, on a motion by Mr. Costello and seconded by Mr. Fay the meeting adjourned at 10:29 a.m.

Respectfully submitted,

Seth Magaziner,
General Treasurer